



## Thinking About the Implications of Rising Euro-Exit Risks

The risk of one or more countries leaving the euro – or indeed the euro breaking up into national currencies or new smaller currency blocks – is no longer something to casually dismiss. The volume of PIMCO client questions on this topic attests to this. The possibility is also no longer politically unthinkable. French President Nicolas Sarkozy and German Chancellor Angela Merkel contemplated the previously unimaginable last November when they said, “The question is whether Greece remains in the eurozone.”

So even if the euro survives this crisis intact, scenario planning is indispensable for investors. Indeed, even if no country actually leaves the euro, investors need to think about the implications, because the market will price in this uncertainty as the euro debt crisis evolves. As 19th century British Prime Minister Benjamin Disraeli famously said, “I am prepared for the worst but hope for the best.”

Here’s hoping for the best. But we also want to offer investors a framework for thinking about – and positioning for – “the worst.”

First, we must think about how a country may leave the eurozone and therefore be ready to reassess the probability of that risk if some of the anticipated signposts begin to materialize. Second, by thinking about the economic and market spillovers, we can reassess the correlation of other assets to a euro breakup. And third, by thinking about the implications of possible policy responses, we can be prepared to take advantage of opportunities and work to avoid the negative costs that may arise as a consequence.

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Mr. Bradshaw is an executive vice president and portfolio manager in the London office. His main focus is European macro strategy and in particular the evolution and investment implications of the eurozone sovereign debt crisis. He is also a permanent member of the European Portfolio Committee. Prior to joining PIMCO in 2007, he worked at Threadneedle Investment Managers for six years, managing global and sterling bond portfolios. Mr. Bradshaw started his career as an economist at HM Treasury, where he worked for three years. He has 13 years of investment experience and holds an undergraduate degree from Oxford University.

## “Within the eurozone we believe investors should look at alternatives to the government sector, including agency, regional government and covered bonds.”

Remember, regardless of what happens it's likely that rising euro exit risk will be reflected in higher credit premiums for a wider variety of assets, including many eurozone sovereign bonds. This can be countered by reducing credit risk directly or by owning more nominally “risk-free” assets. But establishing what is a risk-free eurozone asset is far from straightforward. For example, the consequences of a credible eurozone policy response mean that the credit quality of German bunds could change for the worse.

Within the eurozone we believe investors should instead look at alternatives to the government sector, including agency, regional government and covered bonds. These have credit characteristics similar to government bonds but typically offer higher yields. In addition, we think investors should consider increasing the duration risk in other developed government markets and reduce exposure to the euro itself. Finally, faced with such uncertainty, it makes sense to increase and diversify holdings of cash or near-cash instruments.

### Preparing for the worst, hoping for the best

#### How might a country exit the single currency?

In brief, it all depends on political, not legal, decisions. The Lisbon Treaty governing the European Union makes no provision for leaving the single currency but does allow for a country to negotiate its exit from the EU. (A reminder/primer: The EU is the single market of 27 European countries allowing free movements of goods and services and jobs. The eurozone consists of 17 EU countries that have agreed to share the single currency and have a common central bank, the European Central Bank, or ECB.) In short, this means that a country could leave the eurozone unilaterally by simply breaking EU

treaties, or it could leave with the agreement and potential support of other EU partners. The first course of action is likely to have more severe economic spillovers, while the second is likely to involve protracted political negotiations.

The most likely spark for a euro-exit will be local social and political unrest driven by prolonged recession. Although a country cannot legally be forced out of the eurozone, EU policymakers could also adopt policies that made it very difficult for a country to stay.

There are many different breakup scenarios. At one extreme Greece, possibly joined in time by Ireland and Portugal (the other EU/IMF program countries), could leave the euro and revert to their own national currencies. At the other extreme, the euro may cease to exist and all 17 euro countries could revert to their own national currencies. In between is the possibility of a severely trimmed down eurozone, for example a “Northern Bloc” consisting of countries with very similar economic characteristics and without Spain and Italy. Not to be dismissed is the possibility that the northern European countries leave the euro themselves. As a general rule, the larger the size of the departing economies, the greater the market and economic dislocation we should expect.

The Lisbon Treaty suggests that a country leaving the eurozone should also leave the EU, but this is not obviously the case. If a country left the EU, the economic costs would be great because it stands to lose associated trade privileges, capital and labour mobility and, in many cases, EU transfers. However, euro-exit is likely to be a political, not legal, decision. As such, it is possible that

a euro exit could be negotiated while retaining EU membership.

All these political changes may take some time to occur. But the signposts that will help us reassess the probability of a euro exit by any country are: greater domestic political advocates for such an outcome, continued economic stagnation with high and rising unemployment, continued social unrest, continued capital flight and growing unwillingness of other eurozone governments to provide financial support for the policy status quo.

### **What happens next to my bonds?**

The departing state is likely to issue a new law redenominating all domestic contracts into local currency at a fixed exchange rate. Investors therefore need to be aware of their bonds' governing law. Bonds issued under domestic law would probably be redenominated into local currency and investors would now face additional currency risk.

Capital controls and severe financial repression are additional risks investors should expect to face. Given their weaker balance sheets, we'd expect capital to quickly flow out of the peripheral economies in anticipation of a large currency devaluation. Inevitably, governments will try to avert bank failures by imposing deposit and capital controls. The only way to address this would be by holding higher-than-usual liquidity cushions outside of the country at risk of leaving the eurozone.

But having a bond issued under English or New York governing law does not unambiguously address these risks. If the bond documentation gives jurisdiction to local rather than foreign courts, the bond could be

redenominated. Foreign courts may also judge whether there is a "presumption" that the payment would be made in euros or in the currency of the departing state. If the euro is not clearly stated as the "currency of payment," courts could use the "place of payment" to determine whether the bond should be redenominated into the currency of the departing state.

Finally, if a euro-exit is politically negotiated it may be accompanied by an EU directive that compels all EU courts to give primacy to local redenomination law.

Investors' positions become even more unfavourable if the calamitous event comes to be and the euro ceases to exist. At this point the euro would cease to be legal tender in Europe, and investors probably would have little option but to redenominate into the local currency at the rate of the government's choosing.

The only way to help mitigate these risks is to hold fewer assets in the country at risk of euro exit. In cases where this does not make sense – for example, because valuations are attractive while the perceived risk of euro exit is very low – investors should think about diversifying the location of their liquid assets as well as holding higher-than-usual liquidity buffers.

### **How a euro exit may affect a bond's credit quality**

Unfortunately, investors cannot sit comfortably even if the euro survives and their bonds are not redenominated into a new currency. That's because they still may face a sharp deterioration in their bond's credit quality.

A country's exit from the euro is not a decision to be taken lightly and would result in considerable economic dislocation.

The crises in Iceland (2008) and Argentina (2002), where capital controls were introduced, are useful for gauging the size of potential economic and financial disruption. The Icelandic kroner fell 50% and the Argentine peso 70% against the dollar. Inflation soared: it peaked at 22% in Iceland and 40% in Argentina. Growth was eventually restored, helped in large part by stronger external demand, but the initial response was a further fall in output and higher unemployment.

Companies located in the departing country would likely face the sharpest credit deterioration. Default risks could rise sharply for corporates with significant local revenues and euro-denominated liabilities. Recovery rates would likely also decline, not least because investors should not expect favourable hearings when seeking local court enforcement. In addition, the risk of capital controls and government appropriation of assets or profits by heavy taxation or decree means that credit analysts would have to closely examine the corporate governance of globally diversified businesses too. The bottom line is that as the risk of a euro exit rises, the credit risk of all securities issued out of the departing country also increases.

### **Contagion risks – reassessing portfolio risks**

#### **Implicit foreign currency risk across the euro-government market**

If one country leaves the eurozone it sets a precedent that other eurozone countries, faced with this or some future crisis, could follow. The eurozone formally morphs from a single currency into a fixed exchange rate regime where

exchange rates are no longer “irrevocably fixed.” This sentiment effect means that as the risk of one country leaving the euro increases, it increases the implicit foreign currency risk of not only its own debt, but also the debt of others sharing the euro. This rising risk would likely be reflected in higher bond yields on euro-denominated debt.

This foreign currency risk is significant even for economies not nearly as imbalanced as Iceland and Argentina were. Indeed, the pound sterling fell 22% against the euro as its banking crises unfolded during 2008-09. Even relatively stable European economies have significant foreign currency volatility; the Swedish kroner appreciated by only 0.5% against the euro in 2011, yet it had average annualized daily volatility of 8.3%.

#### **More losers than winners in Europe**

Foreign currency risk is a zero-sum game: One currency falls at the expense of another’s rise. However, the peculiarities of euro-redenomination mean that most countries would probably see higher bond yields on their euro-denominated debt.

In addition to accelerated capital flight from the periphery, capital will probably begin to leave the eurozone as a whole. Economies with relatively small current account deficits (such as France) or small and hence less liquid markets (such as Austria and Finland) could become more vulnerable to capital flight and experience rising bond yields.

As the anchor of the system, German bunds should benefit from intra-eurozone capital flight. It seems reasonable to expect these intra-euro capital flows,

together with domestic repatriation of other foreign assets, to offset any foreign repatriation of capital out of Germany. In short, bund yields will probably fall if euro breakup risks increase.

The chart (Figure 1) shows that this process has been unfolding over the past 18 months. As the crisis engulfed more countries, their yields started to rise while Germany's fell or remained unchanged. This happened in Italy this summer and in France this autumn. The result is that the average eurozone sovereign yield (weighted by GDP and excluding Greece, Ireland and Portugal) is little changed compared to end 2010. This is despite a much weaker economic environment that has delivered lower yields in non-eurozone sovereigns with no better economic fundamentals but greater policy certainty, such as the UK (red line in Figure 1).

Capital flight out of the eurozone would likely weaken the euro against most other major currencies. The

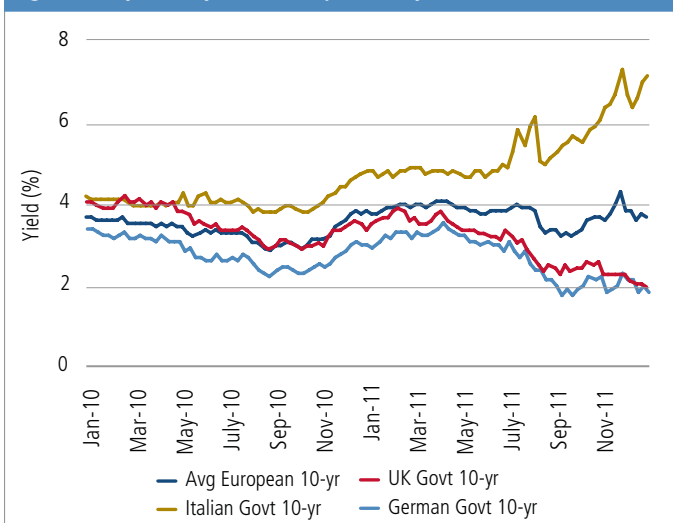
redeployment of this capital should also lower developed sovereign bond yields outside of the eurozone, especially those countries with deeper liquid markets such as the US and the UK. Investing in non-euro developed bond markets therefore offers a degree of protection against euro breakup risks both via potential currency appreciation against the euro and via capital gains from lower yields.

### Implications for global risk assets

Capital flight creates economic deleveraging pressures and increases the likelihood of a deep recession. This has negative implications for other risk assets.

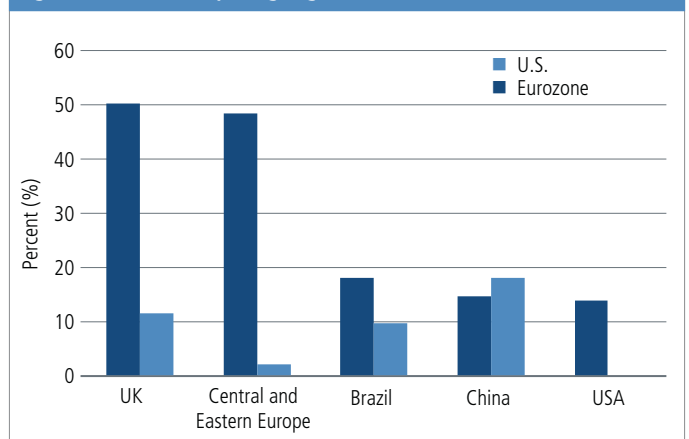
Companies domiciled outside of the departing euro-country but with large revenues or asset exposures to the departing country could suffer permanent revenue losses that upend their business model. Figure 2 shows that other European economies have the largest direct economic exposure to the

Figure 1: Italy's bond yields trend up, Germany and UK down or flat



Source: Bloomberg, PIMCO. Data as of 3 January 2012.

Figure 2: Percent of exports going to Eurozone and USA (2010)



Source: International Monetary Fund, PIMCO, Haver Analytics. Data as of 30 June 2011.

eurozone. But the eurozone represents one-fifth of global output, so a deep recession in the eurozone has significant implications for non-European growth more generally.

Capital flight also increases the pressure on European banks to deleverage their balance sheets more quickly. At \$41 trillion, eurozone banks' balance sheets are about 2.5x larger than US banks', and their asset book is globally diversified with a combined 17% resting outside of Europe, according to figures from the Bank for International Settlements and several central banks. Deleveraging European banks therefore have global implications.

European banks will first seek to sell securities in non-core European markets. This may result in sharp price declines in securities seemingly unconnected to the eurozone crisis. European banks will also attempt to reduce credit in other foreign markets. Outside of the eurozone this has significant implications for emerging economies in Central and Eastern Europe, where European bank lending accounts for almost

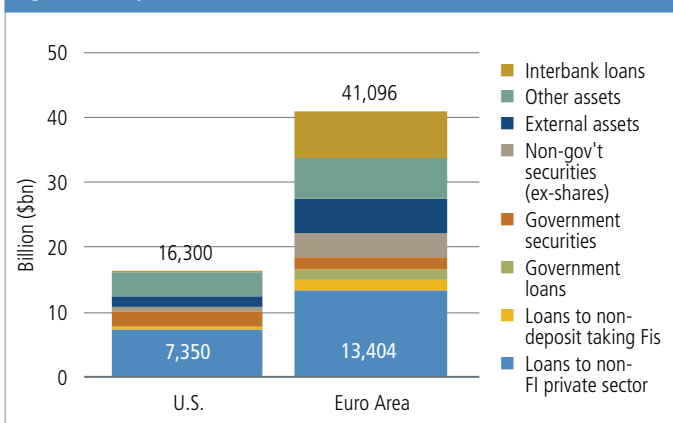
40% of GDP. There may also be implications for credit availability in stronger emerging economies in Latin America, although here the stronger underlying growth dynamics suggest European banks would find more willing buyers for these franchises.

### Anticipating policy responses

The scenarios painted above are far from inevitable. Indeed, investors should anticipate a policy response at every turn that tries to avert them from unfolding. Thinking about the implications of an effective policy response now means investors should be prepared to reposition portfolios quickly and potentially benefit from the opportunities and avoid the negative costs associated with different policy responses.

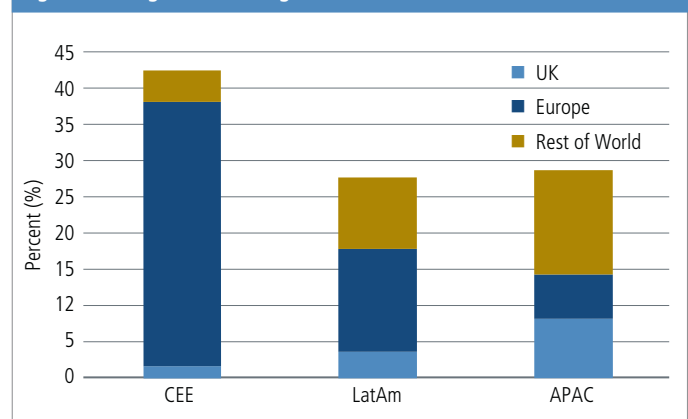
As the risk of a country leaving the euro increases, the ECB would need to intervene in markets more assertively in an effort to mitigate capital flight from sovereign and banking capital markets. Besides providing more generous funding, the ECB would need to help stabilize the asset side of banks'

Figure 3: Comparison of U.S. and Euro area bank assets



Source: PIMCO, Bank of International Settlements, European System of Central Banks, Bank of England, Federal Reserve, Barclays Capital. Data as of 30 June 2011.

Figure 4: Foreign bank lending as % of EM GDP



Source: PIMCO, Barclays Capital, Bank of International Settlements, Citigroup. Data as of 30 June 2011.

balance sheets by stabilizing government bond prices. Politics may prevent the ECB from buying government bonds in the same manner as the BoE and the Fed, but the ECB could provide funding support and expand its balance sheet more indirectly via a special government or banking intermediary. This balance sheet expansion, other things equal, would be a negative for the euro currency.

Credible ECB intervention – which would require either overwhelming size or clear policy communication – would in the short run be positive for the sovereign bonds targeted by the ECB. But the loss of European policy credibility to date and the absence of any growth strategy mean that ECB action on its own buys time but will only be deemed successful if it bridges to a complementary response from eurozone governments.

Higher implicit foreign currency risk in euro sovereign debt requires political leaders to show the strong leadership that has been lacking to date and agree to greater fiscal and political union that clearly ties the remaining countries into a “single currency.” This can take many forms, but the implications are that the strong eurozone sovereigns, such as Germany, take on more fiscal responsibility for supporting pan-European growth and providing financial support to the periphery. This policy response would imply a convergence of eurozone sovereign yields, with bund yields going up and peripheral sovereign yields going down.

### **Investment conclusions**

Rising risk of a euro exit means higher credit risks. Yet investors looking for a eurozone risk-free asset to reduce their portfolio credit risks do not have perfect options. The

absence of a credible eurozone policy response means that we should expect more eurozone sovereign debt to behave like credit rather than interest rate risk. German bund yields might initially fall as the crisis intensifies, but bunds’ credit quality could change quickly, irrespective of the macroeconomic backdrop, if a credible policy response finally emerges. Instead, investors will need to increasingly look outside the eurozone government market for alternatives with similar credit risks but more attractive valuations, such as government agencies, regional government debt and covered bonds issued in euros but by countries with either strong balance sheets or good policy credibility.

We believe reducing portfolio credit risk by owning interest-rate risk outside of the euro also makes sense. Rising euro exit risks increase deleveraging pressures. This is negative for global growth, though non-eurozone developed market government bonds could benefit. The rising possibility of capital flight out of the eurozone would also be negative for the euro against most other developed currencies.

Finally, when faced with such a “known unknown,” investors should consider increasing and diversifying their holdings of liquid assets to help increase their ability to withstand a market shock.

A “risk free” asset refers to an asset which in theory carries no risk of default and guarantees the return of principal and interest. All investments contain risk and may lose value.

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